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TECHNICAL SUPPORT AND POLICY COORDINATION IN EFFICIENT RURAL FINANCIAL MARKETS

by

Richard L. Meyer

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Agricultural Finance Program

Department of Agricultural Economics

and Rural Sociology

The Ohio State University

Columbus, Ohio, 43210

Introduction

There has been an explosion of studies about the status and problems of agriculture in Africa and Nigeria in recent years. The poor performance experienced in many countries has been blamed on a variety of factors including price controls, marketing boards, insecure land titles, inappropriate technology, underdeveloped research and infrastructure, difficult ecological conditions, urban policy bias, and a weak human capital base in agriculture. There have also been a good number of studies about agricultural credit, and there are more academic publications on the subject in Nigeria than any other African country. The credit studies also identify a long list of problems. Paradoxically, at the same time, a number of studies document the successful performance of several types of informal financial systems in Africa.

This situation leads me to conclude a) that simple solutions are not likely to be found for complex agricultural problems, b) that it is not surprising that financial instititions experience great difficulty when trying to serve a sector with so many problems, and c) that there must be some systematic problems in the design and operation of formal financial systems that explains their poor performance compared to informal systems. The solution to these agricultural and financial problems is likely to involve coordination among several simultaneous programs rather than one single program or policy.

The title for this session was given as "Technical

Support and Policy Coordination in Efficient Credit Systems". I have broadened the title to rural financial markets because it seems to me that the long-term development needs of Nigeria reguire a strong self-sustaining system to provide financial services in rural areas. For some rural households, the important service will be loans; for other households it will be deposit services; and some households will use both types of services simultaneously. The issue then is to identify the type of support and policies useful in the development of a viable rural financial system. A viable system is one that mobilizes funds from savers, allocates them to borrowers, and recovers the loans. Interest income is sufficient to cover costs and default risks, and incentives are given that encourage institutions to search for innovation and efficiency. A wide variety of government interventions affect the process of rural financial intermediation and the viability of financial institutions. These are identified and briefly discussed in the next few pages.

Financial Policies

1. Portfolio controls. One of the most basic financial principles is portfolio diversification. Specialized financial institutions by design concentrate their portfolios in certain sectors, economic activities and borrowers. Targeting rules and quotas that require lenders to lend for specified uses, borrowers or regions create the same concentration. Financial institutions must be permitted the flexibility to diversify

their loans and other assets in order to reduce risk and increase the probability of survival in the face of adversity.

2. Interest rate controls and reserve requirements. Four problems have been found in many countries regarding the current structure of interest rate controls: a) low deposit rates discourage savings, b) authorized spreads or margins are too low to cover costs, c) loan rates are too inflexible to compensate for different levels of loan risk, and d) loan and deposit rates are too inflexible relative to changes in inflation so real rates are often negative. Even if institutions recover all loans made, they are not able to mobilize adequate funds and the real value of their funds decline over time. Furthermore, reserve requirements are frequently set at high levels to generate funds for government use. This "tax" places a heavy burden on institutions and reduces their income earning potential. Both sets of rules must be carefully evaluated to determine the extent to which they are sapping the strength of financial institutions.

3. Loan Guarantees. Many countries use loan guarantee programs to induce lenders to lend for priority purposes. If loans for these priorities are viewed as highly risky, the guarantee may not provide sufficient incentives for lenders. The procedures for getting reimbursed by the guarantee fund are often so cumbersome and costly that lenders do not perceive the fund to be of much value. On the other hand, if procedures are simple the claims for losses may bankrupt the fund. The most important guarantee in many cases is a legal system for loan

recovery and liquidation of pledged collateral that is swift, just and free of political intervention.

4. Experimentation and cost-reducing innovations. The provision of banking services to a large number of geographically dispersed low-income rural households in a cost-efficient manner presents a difficult challenge. Current regulations in many countries discourage experimentation necessary to discover techniques useful to improve service and reduce costs. Some regulations prevent partial service bank branches even though all the services available in a full service branch may not be used in rural areas. Work rules often need to be more flexible so bank employees in small branches can perform multiple tasks. Hours of operation, on the one hand, may have to be fewer than in a regular branch but, on the other hand, be scheduled when rural customers want service. These changes may increase the demand for formal financial services by reducing transaction costs for users.

5. Reporting and supervision. Studies have shown that the reporting and other costs of participating in government and donor credit programs have been much higher than for programs that lenders design themselves. Authorized spreads have been shown to be far too small to cover these costs. Another disturbing feature of many reporting systems is that they provide little information of the type that management needs to make decisions for improving performance and viability, but they consume scarce staff time and clog information channels. Reporting systems in both central banks

and bank head offices frequently need to be restructured with less emphasis on amount of lending for various purposes (which has little relevance to efficiency of operations) and more attention to information on costs, loan delinquency, and efficiency and risk measures. Supervision should focus more on improving and evaluating staff performance and less on supervising borrowers in their use of loan funds.

6. Bank inspection. Many central banks are too understaffed and poorly trained to do an adequate job of bank inspection. This situation can contribute to a loss of faith in the banking system, avoidance of rules necessary for sound operations, and a failure to punish corruption resulting in an inability to mobilize deposits and prevent losses. This area if often one that requires training and development in the central bank.

Nonfinancial Policies

Several nonfinancial policies need to be changed and coordinated with financial policy changes to create a supportive environment in which financial institutions operate.

1. Profitability and risk in agriculture. One of the reasons commercial banks resist lending to agriculture and encounter so many difficulties when making agricultural loans is due to the inherant riskiness of farming. Even more important in many cases, however, are the policies adopted which reduce farm profits and incomes, and increase rather than decrease price uncertainty. Farmers with low and uncertain

prices are poor customers for lenders, and institutions will likely fail if they concentrate a large share of their portfolio in agricultural loans. Financial institutions can thrive when both they and farmers can predict income and profits with some degree of certainty, and when both fully expect repayment on loans regardless of how wrong their predictions turn out to be. The several changes underway in many countries to improve farm prices, exchange rates, supplies of inputs, irrigation systems, plant and animal protection, agricultural research and extension, and in other ways increase income and reduce risks may accomplish more to stimulate agricultural lending than the complex set of rules and incentives employed in past years. Countries that fail to implement such changes should expect serious problems to continue in their rural financial institutions.

2. Infrastructure investments. Additional infrastructure investments in rural roads, transportation, and communication are being stressed in many countries because of the expected positive impact on agricultural production and marketing. These investments can also be of great assistance in the development of rural financial markets. First, such investments can reduce the cost of operating distant branchs of financial institutions and, thereby, encourage an expansion in rural banking. Second, these investments can also reduce the time and effort required by rural households to travel to and communicate with financial institutions. This will reduce the transaction costs of borrowing and maintaining a deposit

account. Combined with an improvement in bank service, these changes can have a powerful influence on monetization of the rural economy and the demand for formal financial services.

3. Legal system. Many countries inherited their legal systems from former colonial powers. These systems may no longer be adequate to support modernizing economies. In addition, political considerations have permeated the actions and procedures of some legal systems to a disturbing degree. Unless corrected, this situation can be a major impediment to financial growth. Depositors must have confidence that their scarce savings are carefully protected, that the institutions that hold their deposits make prudent investments, and that an insurance system is in place to compensate them in the event of institutional failure. Borrowers must anticipate that there will be a swift and just system to collect their loans or liquidate the collateral pledged for loans in the event of default. Lenders must also know that this system is dependable and reasonably efficient so it can be used as a last resort to recover their funds when borrowers default. This system must also support bank management and inspection so that bank employees who engage in fraud are quickly punished.

Initiatives of a Central Bank

Much of the discussion above emphasized the rule-making functions of a central bank. There are several activities that a central bank can undertake that will strengthen rural financial markets.

1. Experimentation in institutional forms and financial innovations is needed to discover ways to provide cost-effective financial services in low-income rural areas. The central bank can facilitate this process by transferring ideas that have worked in other countries and encourage the testing of them in local conditions.

2. Supply-leading financial strategies have focussed on using the rediscount window of the central bank to provide funds for priority lending. Emphasis now needs to be placed on assuring quick access to central bank funds to smooth out uneveness and seasonality in the supply of and demand for funds in local financial institutions. Likewise, the central bank can facilitate systems for the intrabank and interbank transfer of funds to ease the cash flow problems of local institutions.

3. The recordkeeping and reporting systems of many central banks and financial institutions are currently heavily oriented towards tracking lending activities. Central banks can take the lead in restructuring these systems so that total reporting costs are reduced at the same time that information is collected and processed that will be of more use in inproving financial efficiency and institutional viability.

4. Developing and maintaining a strong rural financial market will require research and monitoring. Research will be needed on issues such as measuring the operating costs of financial institutions, projecting default risk, and estimating the minimum spread required to assure institutional viability. Transaction costs experienced by rural customers in making

loans and deposits also need to be monitored to determine if the financial system is improving service and moving to greater efficiency. Consumer preferences for financial instruments need to be studied so that new instruments can be created and tested. Some of this research can be done by research institutes and head offices of financial institutions, but some of it must be done by the central bank in order to improve its policy making capability. This task will require that research offices be created and/or strengthened within many central banks.

5. Additional training will be required for staff working in financial institutions when they begin to mobilize more deposits and develop localized lending programs for the funds mobilized. Central bank rules and regulations regarding the details of bank operations will become less important in day to day operations as institutions begin to make more of these decisions for themselves. The central bank can contribute to the development of the necessary human capital by giving training on subjects such as estimating a loan applicant's cash flow and debt repayment capacity, and the riskiness of certain types of loans. Some of the training needed for effective deposit mobilization and management of deposit accounts may be obtained from local commercial banks already experienced in such matters.

Conclusions

The development of strong self-sustaining rural financial markets in Africa, and probably Nigeria, will require significant changes in several national financial and nonfinancial policies and programs. The changes currently being introduced in many countries to improve farm incomes and reduce risks are likely to greatly improve the conditions for successful rural financial intermediation. The next step involves making a variety of changes in the financial system to take advantage of these improved conditions. This paper briefly discussed some of these changes. There are signs in several developing countries that the monetary authorities are moving away from heavy involvement in resource allocation issues and towards more emphasis on regulating and encouraging the development of strong rural financial institutions. This change places a great burden on central banks to design the appropriate supportive policies and programs. Many central banks will need to be strengthened if they are to meet this challenge. More academic study programs and in-service training, and stronger networks for regional cooperation and exchange of ideas should be part of the agenda for rural financial development.